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UNITED STATES TAX COURT
WASHINGTON, DC 20217

F. LEE BAILEY, ET AL.,	)	
	)	
Petitioner,	)	
	)	
v.	)	Docket No. 3080-08, 3081-08.
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent	)	

ORDER

Petitioner F. Lee Bailey filed a motion under Rule 161 asking the Court to reconsider its opinion of April 2, 2012, in Bailey v. Commissioner, T.C. Memo. 2012-96, with respect to four issues. By order of May 25, 2012, the Court denied Mr. Bailey's motion as to Issue III (due process) and Issue IV (set-off) and ordered the IRS to respond to the two remaining issues--*i.e.*, Issue I (pension proceeds) and Issue II (business use of aircraft). Upon consideration of the IRS's response and Mr. Bailey's reply, we will deny Mr. Bailey's motion for reconsideration with respect to Issues I and II.

I. Pension income

Mr. Bailey asks us to reconsider our conclusion that he had unreported pension income of $69,527 in 1999. Bailey v. Commissioner, T.C. Memo. 2012-96, slip op. at 110. Our opinion concluded that Mr. Bailey "did not show that he or his wife reported this income, and he did not show how a payment to his mother-in-law could have reduced their tax liability for tax on the pension income". *Id.* Mr. Bailey argues that our conclusion is contradicted by the evidence, which shows (he says) an "oral trust" that makes the pension proceeds not taxable to him. He acknowledges that his wife Patricia Bailey had named him as the beneficiary to receive the pension proceeds in the event of her death, and he does not dispute that the pension proceeds were paid by means of a check made out to him. He does not allege that she gave contrary instructions in a will or executed a revised beneficiary designation. Rather, at trial he testified as follows:

Mr. Bailey said that Mrs. Bailey's mother, Lana McGovern, owned a half interest in a condominium, the other half of which Mr. and Mrs. Bailey owned as joint tenants, and that a mortgage loan had been taken out on the condo. He testified that his wife Patricia had orally instructed him, before her death, that (1) if Mrs. Bailey predeceased Mrs. McGovern, then Mrs. McGovern was to receive the other half interest so that thereafter she would own the condo in its entirety, and (2) Mr. Bailey was to use the proceeds of Mrs. Bailey's pension to pay off the mortgage on the condo, so that Mrs. McGovern would own the condo free and clear. As to the pension proceeds, Mr. Bailey contends that Mrs. Bailey's instruction created an oral trust in Mrs.

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McGovern's favor with Mr. Bailey as the trustee, owning only a legal interest and not a beneficial interest in the pension proceeds. Accordingly, Mr. Bailey argues that the lump sum pension payment should not have been included as income to him.

We find Mr. Bailey's testimony credible to the extent of Mrs. Bailey's having orally expressed the desire that Mr. Bailey would use the proceeds from the pension to assure that Mrs. McGovern would own the condo free and clear of any mortgage. However, even giving credence to that testimony, and assuming (without deciding) that the creation of an oral trust would have the tax effect for which Mr. Bailey argues, other anomalies and unanswered questions in the evidence raise doubts about the existence and terms of an oral trust, and bring us to the conclusion that she simply expressed a desire. Mr. Bailey does not say, and our record does not show: whether or not Mr. or Mrs. Bailey was liable on the condo's mortgage loan; nor the amount of the mortgage debt; nor how Mrs. McGovern was to become the owner of <u>Mr.</u> Bailey's interest in the condo (nor whether she ever did); nor that Mrs. McGovern reported the pension proceeds as her own taxable income.

Proof of an oral trust should include a coherent and precise account of the nature of the trust. However, in support of his motion for reconsideration, Mr. Bailey states, "Had Mrs. McGovern predeceased her daughter, the lump sum payment would have vested to petitioner's benefit after Patricia's death." This apparent remainder interest in Mr. Bailey's favor, however--first mentioned in his motion for reconsideration and not disclosed in Mr. Bailey's testimony about Mrs. Bailey's oral instructions--adds unelaborated and unexplained complexity to the arrangement. By this account, Mr. Bailey evidently <u>did</u> have a beneficial interest (albeit a contingent interest) in the proceeds, making it clear that not <u>all</u> of Mrs. Bailey's oral comments were described in the trial testimony, and leaving us unable to say what the further details of those instructions may have been. Moreover, in the absence of any evidence about the mortgage loan--the payment of which was supposedly the explicit purpose of the alleged oral trust--we cannot say whether Mrs. Bailey's instructions would have called for paying off not an obligation of Ms. McGovern but an obligation of, say, Mr. Bailey. Even if paying off a mortgage loan that was owed by Mr. Bailey would indirectly benefit Ms. McGovern by removing a lender's security interest in the condo, that arrangement would not have excused Mr. Bailey of tax liability on the proceeds by depriving him of the benefit of the proceeds. Rather, he did benefit, if the proceeds paid off a debt that he owed--an outcome we cannot rule out on this record.

Proof of an oral trust should also include evidence showing compliance with the trust's alleged terms--in this case, the use of the corpus to pay off the condo mortgage. Such evidence is not present here. Mr. Bailey testified instead that he had a check written to Ms. McGovern in an amount roughly equal to the pension proceeds. While it is possible that Mrs. McGovern then used that check to pay off the mortgage, the record does not indicate whether this in fact happened nor (more to the point) why Mr. Bailey as trustee did not himself pay off the mortgage directly, as the trust supposedly required.

We therefore cannot conclude that Mr. Bailey proved, by a preponderance of the evidence, that Mrs. Bailey created an oral trust that would have affected his liability for tax on the pension proceeds. Moreover, the standard of proof to which Mr. Bailey should be held on this issue may be higher than a mere preponderance of the evidence. If we were to hold in Mr. Bailey's favor and conclude that an oral trust was created, with Mr. Bailey retaining no beneficial right to the payments notwithstanding the terms of the pension contract, then any proceeds not taxable to him should have been taxable to Mrs. McGovern. However, given that the proceeds were paid in 1999 (i.e., ten years before the trial in this case), it seems all but inevitable that the period of limitation on assessing tax on Mrs. McGovern has closed and that no additional tax could ever be assessed. See sec. 6501 (3-year period for assessment).

Mr. Bailey's position, if it succeeded, would therefore excuse the payee (himself) from tax on apparent income and would shift the liability to someone unknowable by the tax collector--i.e., the beneficiary of an oral trust. The law abhors such asymmetry or "whipsaw". In the United States Court of Appeals for the First Circuit (to which an appeal in this case would be taken), that abhorrence reflects itself in a heavy evidentiary burden that is put on a party to a contract who seeks a tax treatment at odds with the terms of a contract. See Muskat v. United States, 554 F.3d 183, 188-189 (1st Cir. 2009) (to alter an allocation in a written agreement for tax purposes, "the proponent must adduce 'strong proof' that, at the time of execution of the instrument, the contracting parties actually intended the payments to compensate for something different"). Here Mr. Bailey asks us to uphold a tax treatment at odds with the apparent terms of the pension contract, which named Mr. Bailey in his individual capacity (not as a trustee) as the death benefit beneficiary. If we treat this situation as analogous to Muskat and therefore look for "strong proof" of an oral trust, that strong proof is certainly lacking.

Mr. Bailey's imprecise description of the nature and execution of the trust leaves too many unanswered questions. We are left with the undisputed fact that Mr. Bailey was the named beneficiary of the pension contract and received the proceeds in a check payable to him. We therefore conclude that the payments were taxable income to him. We leave undisturbed our finding that Mr. Bailey "did not show that he or his wife reported this income, and he did not show how a payment to his mother-in-law could have reduced their tax liability for tax on the pension income".

II. Aircraft Related Expenses

Mr. Bailey's motion also asks us "for a clearer finding on the issue of the business use of aircraft operated by Bahamas Enterprises/RAD [Roamer Aircraft Division] for purposes of allowing operational and other costs of these airplanes as a business expense". The Court believes it resolved this issue insofar as it concerns expenses in 1993 and 1994 incurred under the auspices of Bahamas Enterprises, as to which the Court upheld the disallowances of relatively small amounts that the IRS contended were not substantiated. However, the IRS "agrees with petitioner that the treatment of the expenses (and income) reported with respect to [the RAD] 'line of business' of Palm Beach Roamer (PBR), petitioner's wholly owned S-corporation, is not clearly delineated in the Court's opinion." As to these expenses--incurred under PBR's auspices whether before or after Bahama Enterprise's aircraft activity was transferred to PBR--we acknowledge our opinion is not explicit.

The parties agreed that PBR was made up of three separate "lines of business": yacht activities, Project 288, and RAD. Our opinion acknowledges this delineation and draws conclusions regard the business purpose of the yacht activities and Project 288. Bailey v. Commissioner, T.C. Memo. 2012-96, slip op. at 80-99. However, the parties' positions on the nature of RAD (and the extent to which PBR income and expenses were attributable to RAD) have shifted somewhat during and after trial. We left unresolved some disputes involving RAD's aircraft expense, and reconsideration on this issue is appropriate.

A. Background

1. The pleadings

The notice of deficiency issued to Mr. and Mrs. Bailey for tax years 1993 and 1994 states:

> Due to examinations of Palm Beach Roamer, Inc. and Bahama Enterprise, Inc., there are flow through adjustments to your tax returns. The increase in flow through income is \$401,582.00 and \$583,847.00 for the tax years 1993 and 1994, respectively. Accordingly, your taxable income is increased by \$401,582.00 and \$583,847.00 for the tax years 1993 and 1994, respectively.

Similarly, the notice of deficiency issued to Mr. Bailey for tax years 1995 to 2001 stated in part:

> Due to an audit of a related S Corporation, Palm Beach Roamer, Inc. no loss is allowed from the corporation. Accordingly, your taxable income is increased by \$1,030,987.00, \$310,530.00 and \$185,000.000 for tax years 1995, 1996, and 1997, respectively.

That notice of deficiency also disallowed without any further explanation the equivalent PBR flow-through losses of \$95,042 and \$90,093 for 1999 and 2001. The IRS had previously issued to Mr. Bailey an examination report of PBR for tax years 1993 to 1999, and the Form 886-A attached to the report concluded:

> Under the provisions of IRC 183, losses in excess of gross receipts will be disallowed. Palm Beach Roamer was not engaged in any activity "for profit". Analysis of the facts and the "nine factors" of the Treasury Regulations and Court cases lead to that conclusion. Taxpayer is a successful full-time lawyer who used Palm Beach Roamer losses as a means of [sic] limit his tax liability.

In allowing losses to the extent of income, the Form 886-A states, "Since well over \$5,707 of amounts otherwise allowable during the year were verified for 1993, all allowed other deductions for 1993 are tier 2 deductions [i.e., deductions allowed to the extent of gross income]". The IRS used similar language verifying unspecified "amounts otherwise allowable" for 1994 and 1995. For 1996 the explanation stated that there were no records provided to support PBR's expenses on the 1996 return. With regard to 1997, 1998, and 1999, PBR had no income, so there was no analysis of "amounts otherwise allowable".

In his petition Mr. Bailey contested the IRS's determinations disallowing PBR's flow-through losses for 1993 and 1994 by stating, "Palm Beach Roamer, a legitimate yacht and aircraft business, experienced losses, not flowthrough income in both of these years." Mr. Bailey made similar contentions for 1995, 1996, and 1997, stating, "Respondent is in error. This alleged increase in taxable income clearly stems from the 'business vs. hobby' issue". (Mr. Bailey's petition does not appear to address the disallowed PBR flow-through losses from 1999 and 2001, but we treat those losses as tried by consent.) The IRS admitted in its answer that the PBR issues related to "business vs. hobby" losses, but denied that its determinations were in error. The IRS did not offer alternative allegations that PBR's flow-through losses were unsubstantiated.

2. The trial

The IRS's pretrial memorandum stated that the resolution of Mr. Bailey's entitlement to PBR's flow-through losses "turns on whether PBR's activities were engaged in for profit within the meaning of I.R.C. § 183." Mr. Bailey's pretrial memorandum likewise reflected an assumption that the issue turns on whether the losses are disallowed by section 183; but his memorandum does tersely assert a contention later made explicit at trial, by stating, "Using aircraft for business travel * * * is not recreational."

At trial Mr. Bailey explained (for the first time in the record) that by the time of the years in suit, BEI and RAD were "an adjunct of the law practice primarily, not engaged in for profit, but with some rentals to offset expenses." This testimony appears to be the first clear indication in the record that this was Mr. Bailey's theory as to RAD. He testified that the BEI and RAD "operated the airplanes for [his] business which was the practice of law". Mr. Bailey's testimony described a policy that, when he flew with employees or colleagues in his law practice, at least one other passenger on board must be able to land the plane in the event of an emergency --i.e., have a "pinch hitter rating". Mr. Bailey explained that he held the aircraft in a separate corporation (rather than the same entity as his law practice) because he did not want to "become personally liable for a rental pilot smashing into somebody's house". When asked if he had any logs documenting the extent of personal use of the RAD aircraft, Mr. Bailey testified, "There is no personal use that I can remember. The notion of personal use probably needs to be defined." (Tr. at 471; emphasis added.) He claims the planes were used either for his law practice or for occasional rentals (with the rental activity ending completely by 1996). However, Mr. Bailey did not have any logs showing the extent of his law practice's use, versus incidental rental use or personal use of RAD aircraft; and he did not give any testimony about using the planes for travel in connection with specific court appearances or other particular events in conjunction with his law practice in the years at issue. Moreover, the record includes evidence that, for some of his substantiated business travel (claimed as deductions on his schedule C associated with his law practice), Mr. Bailey did not fly himself but used commercial airlines. We believe that Mr. Bailey sometimes did fly himself for some amount of business travel, but the evidence offered at trial is not sufficient enable us to find the quantum of that law-practice use of the RAD aircraft.

3. Post-trial arguments

The IRS contended in its post-trial briefing that (1) RAD was not an activity engaged in for profit and (2) to the extent the RAD's expenses were incurred in Mr. Bailey's law practice, there is not enough evidence to show that those expenses were deductible under the Internal Revenue Code, particularly when the more stringent proof standard of section 274 is applied.

In response Mr. Bailey acknowledged that RAD standing alone was not an activity engaged in for profit, but instead asserted that RAD was really a holding company for aircraft used in his law practice, and that his law practice was an activity engaged in for profit.

B. Discussion

Deriving a profit motive for one activity (here, the use of PBR's aircraft) from another business activity (here, Mr. Bailey's law practice) is a permissible way to refute a section 183 disallowance. See Campbell v. Commissioner, 868 F.2d 833, 836 (6th Cir. 1989), rev'g T.C.

Memo. 1986-569 ("The profit motive in these cases need not be isolated and attributed to just the individual or to just the corporation"). We agree that Mr. Bailey's law practice was an activity engaged in for profit, and we find credible Mr. Bailey's general testimony that he used the RAD aircraft in his law practice during the years at issue. However, in order to prevail with the contention that specific RAD expenditures were actually deductible expenses of his law practice, Mr. Bailey must offer the requisite proof to support such deductions. See Rule 142(a). Without such proof, Mr. Bailey's derivative profit motive argument cannot succeed and the IRS's disallowance based on section 183 will be sustained.

In order to claim a business expense deduction a taxpayer must prove the fact of the expenditures, the connection between claimed expenses and business activity, and that the deduction was not related to a personal expense. See secs. 162(a), 262(a).

With regard to whether the expenditures at issue were actually "paid or incurred", sec. 162(a), we conclude that the IRS's statements on the Form 886-A that PBR's expenditures of "amounts otherwise allowable during the year were verified for 1993[, 1994 and 1995]" suffices to show that there was no dispute about the veracity of RAD's aircraft expenditures in those years. For other years at issue except 1996, the IRS did not indicate--either in the notice of deficiency nor in its answer--that it disputed the mere fact of RAD's aircraft expenditures. Therefore, we conclude that, for all but 1996, the fact of RAD's aircraft expenditures is not in dispute.

What the IRS does dispute is Mr. Bailey's asserted *exclusive* use of RAD's aircraft for his law practice. Since the business use at issue relates to aircraft, the evidence that Mr. Bailey must offer is governed by section 274(d). The regulations promulgated under section 274 provide that "a taxpayer must substantiate each element of an expenditure *or use* * * * by adequate records or by sufficient evidence corroborating his own statement." 26 C.F.R. sec. 1.274-5T(c)(1), Temporary Income Tax Regs., 50 Fed. Reg. 46016, 46017 (Nov. 6, 1985) (emphasis added). The elements of "use" are: the percentage of business use of the aircraft, the date of each use, and the business purpose for the use. 26 C.F.R. sec. 1.274-5T(b)(6). In order to constitute "adequate records", documentary evidence is required, 26 C.F.R. sec. 1.274-5T(c)(2), and Mr. Bailey has none. In the alternative, a taxpayer establishing business use by "other sufficient evidence" must corroborate his own statements about the amount of business use of the aircraft with other direct evidence such as oral testimony of witnesses setting forth detailed information about the use, or by documentary evidence. 26 C.F.R. sec. 1.274-5T(c)(3).

Here, the record does not contain the requisite evidence of Mr. Bailey's business use of the RAD aircraft. While Mr. Bailey testified a negation (i.e., that there was no personal use of the aircraft "that I can remember") and a broad generality (i.e., that the planes were used either for his law practice or for rentals), section 274 requires more than his testimony alone. In an attempt to show corroborating evidence, Mr. Bailey argues (without any support in the record) that the amount and cost of weather-related equipment (avionics) that his aircraft carried is evidence that his aircraft were for business and not personal use. He argues (again, without any support in the record) that aircraft heavily equipped with avionics make economic sense only when the nature of the use requires (as he now argues his law practice did) flying in unfavorable conditions. As additional corroboration, Mr. Bailey also asserts his long-time use of aircraft throughout his law practice, dating back to 1965, along with his extensive aviation experience and training. We accept his testimony that he was a long-time aviator who sometimes (but not always) flew himself for his law practice. However, this and the other "corroborating" evidence he offers could support his contention of *exclusive* business use only by strained inference and does not suffice under section 274 as the requisite direct evidence of his law practice's particular uses of specific aircraft on specific occasions in the years at issue.

Moreover, the IRS agent's examination of Mr. Bailey's records revealed substantial commercial airline expenses associated with Mr. Bailey's law practice in 1996. While the extensive use of commercial airlines does not absolutely contradict Mr. Bailey's contentions about his exclusive business use of his own aircraft for additional travel, that use of commercial airlines does, especially in the absence of other corroborating evidence, tend to make less likely his claim that RAD's aircraft were used exclusively for his business travel. If Mr. Bailey was often using commercial airlines for law-practice travel, then it is more likely that other purposes (i.e., use for other than his law practice) justified the maintenance of RAD's aircraft and accounted for their use.

The evidentiary bar that Congress set for the deductibility of aircraft expenditures is extraordinarily high, and taxpayers with considerably better documentation than Mr. Bailey have nonetheless been unsuccessful in meeting the rigorous substantiation requirements of section 274(d). See Weekend Warrior Trailers, Inc. v. Commissioner, T.C. Memo. 2011-105, slip op. at 62-63. This outcome is unfortunate, since (as we noted) we believe that to some extent Mr. Bailey did fly himself for business travel in RAD's airplanes; but we can only guess what that extent actually was. In our order of May 25, 2012, we invited the parties to comment on the following tentative hypothesis:

> If we were to conclude that petitioner did not prove that none of the use was personal, we would therefore be left to make an estimate, bearing heavily against the taxpayer for this inexactitude of his own making. The best measure we find in the record--though it is a blunt instrument--is Revenue Agent Campbell's ratio developed from petitioner's other travel expense in 1996 and used by the IRS for the years 1995 through 2000 to distinguish between deductible business-related travel (i.e., 66.2 percent of the totals claimed) and non-deductible personal travel (i.e., 33.8 percent of the totals claimed). We therefore tentatively expect to allow 66.2 percent of the deductions claimed by PBR for non-Project 288 airplane activity.

After considering both parties' subsequent submissions, we conclude that the use of that ratio would be arbitrary, inappropriate, and not faithful to the standard that section 274 requires us to apply. Instead, Mr. Bailey' testimony of 100 percent business use was very general (and somewhat equivocal); and we are unable to find adequate corroboration of that testimony by other evidence necessary to satisfy the requirements of section 274. If it is true (as Mr. Bailey asserts) that the IRS conceded the business nature of equivalent aircraft expenses in pre- and post-suit years (1991-1992 and 2005-2006), such a settlement does not bind the IRS (nor entitle Mr. Bailey to prevail) for the years at issue in this lawsuit, for the reasons we stated in our opinion (at 87-88).

We conclude that Mr. Bailey has not met his heavy burden to show that aircraft-related expenditures of RAD were deductible expenses of his law practice, and we therefore make no increase in the deductions allowed in our opinion of April 2, 2012.

Therefore, it is

ORDERED that petitioner's motion for reconsideration as to Issues I and II is denied. It is further

ORDERED that the parties shall comply with Rule 155, except that action required under the rule to be taken "within 90 days of service of the opinion" shall be taken within 90 days of service of this order.

(Signed) David Gustafson
Judge

Dated: Washington, D.C.
August 14, 2012